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STATEMENT OF

WILLIAM J. ANDERSON, DIRECTOR

GENERAL GOVERNMENT DIVISION

BEFORE THE

SUBCOMMITTEE ON ECONOMIC STABILIZATION

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

HOUSE OF REPRESENTATIVES

ON

PROFITABILITY OF THE PROPERTY/CASUALTY

INSURANCE INDUSTRY

Mr. Chairman and Members of the Subcommittee:

We are pleased for the opportunity to assist the Subcommittee in its deliberations on the subject of the property/casualty insurance industry. We will address our remarks today to: (1) the industry's pricing strategies; (2) industry profitability; (3) the cyclical nature of that profitability; (4) the financial outlook for the industry; and (5) the current difficulties in the industry.

In addressing these issues, we will make the following points. Property/casualty companies have used a pricing strategy which sacrificed underwriting profit margins in order to generate cash for investment purposes. As a result of this strategy, the property/casualty industry has made, depending upon whose estimates are used, between $52 and $80 billion in pre-tax net gains over the last 10 years. Furthermore, like many other businesses, property/casualty underwriting is subject to profitability cycles. While underwriting losses have mounted since 1980, estimated data for 1985 and the first quarter of 1986 indicate that the underwriting cycle has turned and is now moving in a positive direction. Indeed, the industry itself is projecting substantial net gains over the next 5 years.

The current affordability and availability difficulties in liability insurance are found principally in certain liability insurance lines. The medical malpractice and general liability insurance lines are two lines frequently mentioned by the media within a crisis context. These lines represented less than 9 percent of the total property/casualty business, but more than a quarter of all underwriting losses, over the last 10 years.

I will now discuss these points in greater detail. In doing so, I will explain the sources of our data and the scope of our work.

PROPERTY/CASUALTY COMPANY PRICING STRATEGIES

A property/casualty company derives its income from two principal areas: underwriting gains, which are the excess of premiums over claims and expenses, and investment gains. Because of investment gains, a property/casualty company can have net income even though its premium revenues alone are not large enough to cover claims and expenses (underwriting losses).

Thus, the ability to offset underwriting losses with investment income plays an important role in a company's pricing strategy--that is, the amount it charges for the insurance that it offers. For a number of years, many companies have employed a pricing strategy known as "cash flow underwriting". Basically, companies have been willing to accept lower premiums for certain insurance lines in order to encourage sales and obtain funds for investment. In essence, the strategy has been to sacrifice underwriting gains to attract more business and thereby enhance investment gains. For example, in 1985, claims, expenses, and policyholder dividends exceeded premium revenues by almost 19 percent industry-wide.

Through the increased volume of premiums resulting from this pricing approach, companies were able to generate a larger amount of net cash flow which they could then invest to earn additional investment income. For instance, over the 5-year period 1981-1985, when the industry's claims and expenses exceeded premiums by about 12 percent, its underwriting loss was about $66 billion. Even so, the industry had $97 billion in investment gain which, when offset against its underwriting losses, resulted in a net gain of about $31 billion. The investment gain was made possible, at least in part, by the industry's pricing strategy which generated about $85 billion in net cash flow. The industry was then able to invest these funds at favorable rates.

From 1976 to 1983, investment gains, in the aggregate, exceeded underwriting losses by a fairly wide margin. However, this situation changed in 1984, when underwriting losses for the industry were $19.4 billion, while investment gains were $17.9 billion. Subsequently, some companies sharply raised premiums. In 1985, underwriting losses increased further to $22.6 billion, however, investment gains increased to $30.2 billion resulting in total pre-tax gains of $7.6 billion.

PROFITABILITY OF THE PROPERTY/CASUALTY INDUSTRY

We developed a financial overview of the property/casualty insurance industry using financial data for the 10-year period 1976 through 1985. We obtained the 1976-1985 data from Best's Aggregates and Averages published by the A.M. Best Company. In the table below, we show sources of property/casualty income broken out by underwriting gains, investment gains, and total gains (both pre-tax and after-tax). This table clearly illustrates the results of the industry's pricing strategy to obtain investment income at the expense of underwriting income. While property/casualty companies had about $65 billion in underwriting losses, they also earned about $144 billion from their investments during this 10-year period. Overall, the industry had a net pre-tax gain of about $80 billion and an after-tax gain of about $81 billion.

All Companies -- Consolidated Basis
1976 through 1985
($ in billions)

Underwriting gain	Investment gain	Net gain	Federal income tax	Total gain after-tax
($64.8)	$144.3	$79.5	($1.6)	$81.1

We would like to make two points about our figures which differentiate them from figures developed by others. First, the investment gains include net investment income and both realized and unrealized capital gains. We recognize that unrealized gains are just that, unrealized, and, therefore, are subject to investment risks which could result in lower or higher amounts. However, we have chosen to include unrealized gains in our figures because it is within a company's control to manage its investment portfolio so as to realize these gains while the investments are profitable.

Second, the underwriting losses do not reflect policyholder dividends. We consider these dividends to be voluntary, not mandatory, distributions by the companies. Since the companies are not required to make these distributions, we have chosen to exclude them from our underwriting loss figure.

If we adjusted our figures to exclude unrealized gains and to include policyholder dividends (the approach used by the industry in its calculations), the industry's net gain for this 10-year period would be about $52 billion. In either case, it is within management's discretion to realize investment gains or to not pay policyholders' dividends. This was also the opinion of the National Association of Insurance Commissioners' Investment Income Task Force in 1984.

Another factor that plays a role in assessing the industry's profitability is its "rate of return on net worth." Rate of return on net worth is a common measure used by investors in making investment decisions. The rate of return investors expect to earn in order to commit their funds to the property/casualty insurance industry will depend on how they assess the risk of the industry compared to other potential investment opportunities. Attachment I shows rate of return data published by the Insurance Information Institute for the 10-year period 1975-1984. The attachment shows that the average rate of return for the property/casualty industry was 10.9 percent. Furthermore, the attachment shows how the property/casualty industry's rate of return compared to other industry groups such as banks (12.6 percent), transportation (10.6 percent), and utilities (11.9 percent), as well as all industry groups combined (13.2 percent). It should be noted that, in recent years, the rate of return for the property/casualty industry, as compared to other industries, has declined.

CYCLICAL NATURE OF INDUSTRY PROFITABILITY

While it is important to look at the figures for the most recent years, it should be noted that over the longer period the property/casualty industry has demonstrated profit and loss cycles. We believe that data covering longer periods give a more complete picture of the industry's profitability.

Unlike most other industries, the property/casualty insurance industry is flexible with respect to capacity or supply. During profitable periods, insurance companies can increase their capacity, take varied and greater risks, and generally lower their premium rates to achieve a greater market share. Such actions result in price competition as other firms lower their prices to retain their market share. Price competition results in a change from favorable premium profit margins to unfavorable margins, resulting in the underwriting profit and loss cycles.

Attachments II and III illustrate the cyclical nature of property/casualty industry profitability. Attachment II shows the year-by-year underwriting and investment results for the 12-year period from 1974 through 1985. Column 2 in that attachment, underwriting gains and losses, illustrates the cyclical nature of the industry. The earlier cycle bottomed out in 1975 with a $3.65 billion loss and peaked in 1978 with a $2.55 billion gain. Since 1980, underwriting losses have mounted again. However, available estimates by the industry and others indicate that the loss cycle bottomed out in 1985 and that the cycle has now turned upward.

Attachment III illustrates the cyclical nature of property/casualty stock companies over the past 40 years. For purposes of illustration, we used the combined ratio concept, a ratio of claims and expenses to premium income. The attachment reflects the industry's underwriting results and premium pricing strategy; it does not include investment results. As can be seen, stock companies have had several underwriting cycles since 1945.

FINANCIAL OUTLOOK FOR THE INDUSTRY APPEARS FAVORABLE

From all indications, it appears that the trend towards larger underwriting ratios has peaked. Available industry estimates show that over the next 5 years the industry expects substantial net gains. Our calculations, made from the industry estimates, indicate an expected net gain before taxes of more than $90 billion over the years 1986-1990.

Analysts of the industry also generally predict favorable industry prospects. For example, an August 1985 study by Salomon Brothers, Inc.,[1] forecasts that premiums written will grow at a 12-percent annual rate over the 1985-1989 period. The same study forecasts a 10-percent growth rate for incurred losses over the period. The study forecasts further that total industry profits will rise annually at a rate of 25 percent over the same period. More recently, the A.M. Best Company reported that net premiums written in 1985 had increased by about 22 percent over net premiums written in 1984.

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[1]Salomon Brothers, Inc., Property/Casualty Insurance Organizations, Five-Year Review and Outlook, 1985 edition, August 1985.

Financial results for the first quarter of 1986 provide further evidence of the property/casualty industry's improved financial condition.[2] During the first quarter of 1986, net premiums written increased 26.5% over the first quarter of 1985. A similar comparison showed underwriting losses down 22.7% over this same period. For all lines, the combined ratio after dividends was 109.5% in the first quarter of 1986, compared to 117.2% in the first quarter of 1985. In both the medical malpractice and general liability lines, the combined ratios declined 17 points, compared to the 7.7 point decline for all lines. Furthermore, policyholder surplus increased by a record $6.5 billion in the first quarter of 1986.

PROBLEMS IN MEDICAL MALPRACTICE AND GENERAL LIABILITY LINES

Although the financial outlook for the property/casualty industry as a whole appears favorable, two insurance lines often mentioned as having difficulties in terms of high premiums and lack of availability are medical malpractice and general liability. General liability insurance includes coverage of items like day-care centers, asbestos removal, and municipalities.

The medical malpractice and general liability lines do not represent a major portion of the total property/casualty

[2] "First-Quarter Underwriting Results," Best's Review, Property/Casualty Insurance Edition 87 (July 1986): 10, 103.

insurance underwriting business. Attachment IV shows the relationship of these two lines to other property/casualty lines for the 10-year period 1976-1985. Medical malpractice premiums accounted for less than 2 percent of all property/casualty premiums written during this 10-year period and general liability premiums accounted for less than 7 percent. The data were provided by Best's which reports on 27 insurance line categories. For our purposes, we have shown 9 insurance lines separately and grouped the others into an "All other lines" category.

The figures in this attachment show, however, that as a proportion of all lines, the medical malpractice and general liability lines' losses accounted for over a quarter of all underwriting losses: medical malpractice accounted for 8 percent of total underwriting losses and general liability, 19.4 percent. It should be noted, Mr. Chairman, that for those companies specializing in these liability lines, the proportion of the underwriting losses will likely be higher. It should also be noted that this analysis did not include the investment gains applicable to these lines.

CONCLUSION

In conclusion, Mr. Chairman, available financial information shows that, over the long term, the profitability of the property/casualty industry has been cyclical in nature. The data further indicate that over the last 10 years the industry has been generally profitable. There was an overall loss in 1984; however, the industry projects increasing premiums and more favorable prospects for the next few years. Indeed, the industry returned to profitability in 1985.

That concludes my statement, Mr. Chairman. We would be pleased to respond to questions.

ATTACHMENT I

Average Annual Rates of Return—Net Income After Taxes as Percent of Net Worth for Selected Industries

Year	Property/Casualty Insurance	Banks	Transportation	Utilities	All Industries
1975	2.4%	12.1%	3.7%	9.9%	11.6
1976	10.0	11.5	8.8	10.6	13.3
1977	19.0	11.6	10.1	11.1	13.5
1978	18.1	12.9	13.3	11.3	14.3
1979	15.5	14.1	13.2	12.0	15.9
1980	13.1	13.4	11.3	11.7	14.4
1981	11.8	13.0	13.3	12.7	13.8
1982	8.8	12.0	7.9	12.5	10.9
1983	8.3	12.5	11.6	13.3	10.7
1984	1.8	12.8	12.9	13.4	13.6
Average: 1975–84	10.9%	12.6%	10.6%	11.9%	13.2%

Source: 1985-86 Property/Casualty Fact Book, Insurance Information Institute.

 ATTACHMENT II

Underwriting Gains, Investment Gains, Combined Gains (Pre-tax and After Tax): All Companies -- Consolidated Basis[a] Yearly 1974-1985 ($ in millions)

Year	Underwriting gains/losses[b]	Investment gains/losses[c]	Pre-tax total	Federal income tax	After-tax total
1974	($1,974)	($2,443)	($4,417)	($325)	($4,092)
1975	(3,653)	7,009	3,356	(555)	3,911
1976	(1,726)	7,173	5,447	148	5,299
1977	1,926	5,063	6,989	1,015	5,974
1978	2,548	7,758	10,306	1,389	8,917
1979	24	11,610	11,634	896	10,738
1980	(1,712)	15,870	14,158	593	13,565
1981	(4,464)	10,858	6,394	55	6,339
1982	(8,303)	18,387	10,084	(716)	10,800
1983	(11,088)	19,441	8,353	(1,218)	9,571
1984	(19,379)	17,875	(1,504)	(1,732)	228
1985	(22,597)	30,219	7,622	(2,030)	9,652
Totals: 1974-1985	($70,398)	$148,820	$78,422	($2,480)	$80,902
1976-1985	($64,771)	$144,254	$79,483	($1,600)	$81,083

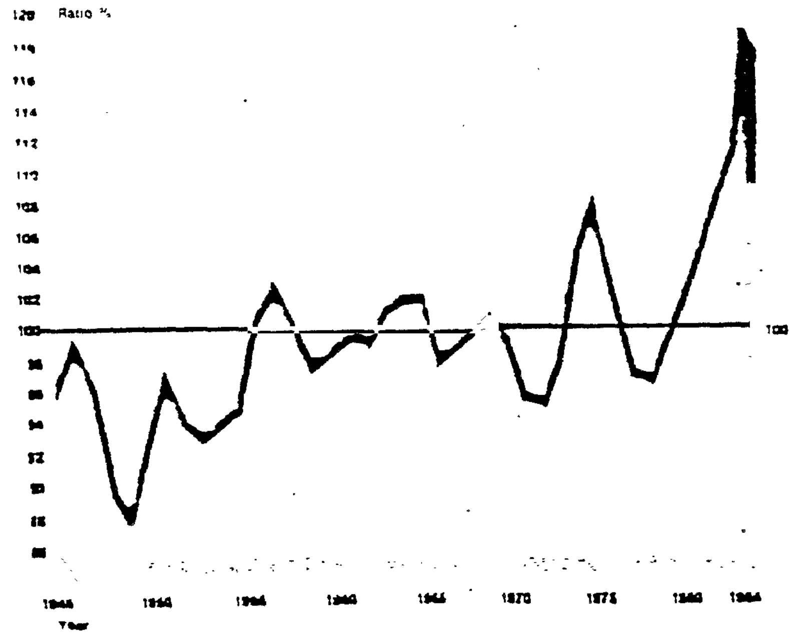
[a]Consolidated totals eliminate double counting by excluding intercompany transactions between parent and subsidiary companies.

[b]Net earned premiums less losses and expenses.

[c]Net investment income plus realized and unrealized capital gains.

Source: A. M. Best Company

Combined Underwriting Ratios for Property/Casualty Stock Companies for the Years 1945-84[a]



Year	Ratio %	Year	Ratio %
1945	95.8	1965	101.9
1946	98.8	1966	98.1
1947	96.3	1967	98.9
1948	91.2	1968	100.0
1949	87.6	1969	100.6
1950	93.0	1970	99.3
1951	97.1	1971	95.8
1952	94.4	1972	95.4
1953	93.1	1973	98.2
1954	93.6	1974	105.0
1955	94.9	1975	107.5
1956	100.5	1976	102.0
1957	102.9	1977	97.0
1958	100.0	1978	96.6
1959	97.8	1979	99.6
1960	98.4	1980	102.4
1961	99.4	1981	104.9
1962	99.0	1982	108.7
1963	101.0	1983	111.8
1964	101.9	1984	119.0

[a] A combined ratio is a ratio of claims and expenses to premium income. Ratios below 100 represent underwriting gains and ratios above 100 represent losses.

ATTACHMENT IV

Net Premiums Earned and Underwriting Gains/(Losses) by Line for 1976-1985 ($ in millions)

Insurance lines	Net premiums earned	Premiums as a percent of all lines	Underwriting gains/losses[a]	Underwriting gains/losses as a percent of all lines
Auto liability (Private passenger)	$192,432	20.47%	($16,506)	25.48%
Auto physical damage (Private passenger)	134,515	14.31	809	(1.25)
Workers' compensation	128,099	13.63	(1,584)	2.45
Homeowners multiple peril	96,376	10.25	(3,833)	5.92
Commercial multiple peril	66,002	7.02	(7,015)	10.83
General liability	62,441	6.64	(12,557)	19.39
Auto liability (Commercial)	46,150	4.91	(8,739)	13.49
Auto physical damage (Commercial)	25,599	2.72	(94)	0.15
Medical malpractice	14,143	1.50	(5,176)	7.99
All other lines[b]	174,362	18.55	(10,076)	15.55
Total - all lines	$940,119	100.00%	($64,771)	100.00%
Total investment gains			144,254[c]	
Total gains before taxes			$ 79,483	
Federal income tax			(1,600)	
Total gains after taxes			$ 81,083	

[a]Net premiums earned less losses and expenses.

[b]Includes such lines as reinsurance, group accident and health, burglary and theft and aircraft.

[c]Net investment income plus realized and unrealized capital gains.

Source: A. M. Best Company